A FURTHER ECONOMIC ANALYSIS OF THE SOCIAL COST OF RETRANSMISSION CONSENT REGULATIONS

by

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April 29, 2005

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My name is William P. Rogerson. I am a professor of economics at Northwestern University and served as Chief Economist of the Federal Communications Commission ("Commission") during 1998-99. I previously prepared an analysis of the economic effects of retransmission consent for the Joint Cable Commenters, which was submitted to the Commission as part of this proceeding.[1] Along with their reply comments, three parties have submitted economic studies disagreeing with some of the conclusions I drew.[2] I have reviewed these studies carefully. In my view they do not refute any of the major conclusions I drew in my first study. In this report I will explain why.

INTRODUCTION

Summary of Conclusions of My Original Study

The essential conclusions that I drew in my original study were: (i) prior to the passage of retransmission consent regulations, over-the-air broadcasting had been supported by a single revenue source - advertising; (ii) retransmission consent regulations created a second revenue source for broadcasters by allowing them to charge MVPDs to retransmit their signals; (iii) since MVPDs pass these cost increases through to their subscribers, retransmission consent regulations

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1 William P. Rogerson, "The Social Cost of Retransmission Consent Regulations," February 28, 2005, ("Rogerson Study"), submitted with Comments of Joint Cable Commenters, *Media Bureau Seeks Comment for Inquiry Required by the Satellite Home Viewer Extension and Reauthorization Act on Rules Affecting Competition in the Television Marketplace*, MB Docket No. 05-28 (rel. Jan. 25, 2005).

2 *See* Michael G. Bauman and Ken W. Mikkelsen, "Response to Comments Regarding Economic Consequences of Retransmission Consent," Economists Inc., March 31, 2005, submitted by Viacom ("Economists Inc. Study"); Jeffrey A. Eisenach and Douglas A. Trueheart "Retransmission Consent and Cable Television Prices," CAP Analysis, March 31, 2005, submitted by The Walt Disney Company ("CAP Analysis Study"); and Mark R. Fratrik "Retransmission Consent: Benefits to Local Broadcasters and Rebuttal to Arguments Against It," BIA Financial Network, March 31, 2005, submitted on behalf of NAB ("BIA Study").

impose a social cost on MVPD subscribers; and (iv) it is not clear that any compensating social benefit exists, *i.e.*, it is not clear that this extra revenue source is necessary for broadcasters to survive or that it has caused them to produce higher quality over-the-air broadcast programming that they would otherwise have produced.

I also described how broadcasters "charge" MVPDs for retransmission consent and how these costs are in turn passed through to MVPD subscribers. Instead of charging MVPDs a stand-alone price for retransmission consent, broadcasters have generally negotiated arrangements with MVPDs where there is no separately identified price for retransmission consent. Rather, broadcasters have bundled retransmission consent for their broadcast signals together with MVPD programming[3] that they also produce and nominally provided retransmission consent "at no extra charge" conditional on the MVPDs' agreement to purchase specified bundles of MVPD programming at specified prices. Of course, this does not mean that broadcasters provide retransmission consent for free, which the broadcasters themselves admit in their comments. They are still able to extract positive compensation for providing MVPDs with retransmission consent through some combination of (1) requiring MVPDs to pay higher prices for MVPD programming that the MVPDs might have purchased in any event and (2) requiring MVPDs to purchase additional programming that they might otherwise not have purchased.

The costs to MVPDs of paying higher license fees than they would otherwise be willing to pay and of buying programs that they would otherwise be unwilling to buy are largely passed on to subscribers in the form of higher subscription prices. Furthermore, to the extent that these

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[3] In this paper I will use the term "MVPD programming" to refer to channels of programming that are not broadcast over the air but are instead created specifically to be shown by MVPDs. These are often referred to as "cable channels." I use to term "MVPD programming" simply to emphasize the point that this programming is carried by all MVPDs.

tie-ins have reduced competition in the MVPD programming market and thereby allowed broadcasters to further raise prices, these price increases have also been passed through to MVPD subscribers. In summary, retransmission consent regulations create a social cost even if they do not damage competition in the MVPD programming market. However, retransmission consent regulations likely create additional social costs because they do damage competition in the MVPD programming market.

Since retransmission consent regulations create significant social costs and since it is not clear that they create significant social benefits that offset these costs, I recommended in my original study that the Commission attempt to more carefully investigate whether or not there are significant social benefits to this policy with an eye towards changing the policy unless evidence can be found that significant social benefits exist that outweigh the costs.

Major Arguments Made by the Three Economic Studies

The three economic studies submitted by parties along with their reply comments attempt to make four major points.

1. Although they are inconsistent on this point, they at times appear to make the argument that the major networks do not have significant market power in the sense that they are not able to extract significant compensation from MVPDs in return for providing them with retransmission consent.
2. They state that, even if retransmission consent has caused increases in cable subscription prices, cable subscription prices have risen by more than can be explained solely by retransmission consent.
3. They state that, even if the major networks have significant market power, the evidence shows that they have not been able to use it to foreclose competition in

the MVPD programming industry because a significant amount of new non-broadcaster-owned MVPD networks have been launched over the last decade since the passage of retransmission consent.

4. They state that allowing broadcasters to indirectly charge MVPD subscribers a fee to view their programming creates incentives for broadcasters to increase program quality and the social benefit of improved program quality more than offsets the social cost of increased MVPD subscription prices.

My main responses to these arguments can be summarized as follows.

1. The bulk of the evidence strongly suggests that networks are able to charge significant compensation for retransmission consent and both the networks and their economic experts have stated this themselves. The studies' attempt to distinguish between market power of the "ordinary variety" that simply allows firms to raise price above cost and market power of the "troubling variety" that is somehow more harmful makes no sense. A social cost is created to the extent that retransmission consent allows broadcasters to indirectly charge MVPD subscribers a fee to view their programming. Regardless of whether or not one characterizes this social cost as being of the "ordinary variety" or the "troubling variety," it is still a social cost.

2. As I understand this argument, the studies are attempting to argue that whether or not the price increases caused by retransmission consent are of a significant dollar magnitude is unimportant so long as they represent a small share of the total increases in cable subscription prices that have occurred. This also makes no

sense. If retransmission consent regulations have caused MVPD subscription prices to increase by a significant dollar magnitude, this is a serious problem that warrants consideration by policymakers regardless of whether or not other factors have also caused additional increases in cable subscription prices.

3. As proof that entry into the MVPD programming industry is easy, the studies cite statistics that show that many new networks not owned by broadcasters have entered the market over the last decade. The flaw with these statistics is of course that they in no way attempt to measure whether or not entry of the new networks was successful or not. Many networks fail soon after their launch and even among networks that do not fail, some may turn out to be much more successful than others. The evidence shows that the vast majority of the most successful networks launched since the passage of retransmission consent are in fact broadcaster affiliated. This suggests that successful entry of non-broadcaster-owned networks since the passage of retransmission consent has actually been quite difficult.

4. As I made clear in my original study, my basic conclusion regarding the issue of the potential social benefits of retransmission consent was that there is almost no evidence of any sort that significant levels of such benefits exist. The three economic studies have failed to provide any such evidence. Instead, they argue that, on a theoretical level, allowing broadcasters to charge MVPDs a price for their product should increase broadcasters' incentives to increase program quality, in much the same way that a firm producing a good in any market will be more

likely to supply a higher quality product if it can charge consumers a higher price. According to this reasoning, since we let producers charge consumers an unregulated price for their product in most markets, then it would also be a good idea to let them do this in the market for broadcast programming. This argument conveniently ignores the fact that the broadcast spectrum is a scarce resource, that society has given a small number of broadcasters access to this limited resource, and that competitive entry of additional over-the-air broadcasters is simply not possible. The fallacy in this reasoning is illustrated by the fact that it clearly "proves too much." That is, the same argument could be used to support the policy recommendation that broadcasters be allowed to scramble their over-the-air signals and directly charge all consumers a monthly fee to rent a descrambling device. According to the logic of the economic studies, this would simply allow a "normal market" to function in broadcasting and therefore benefit consumers. While this policy might theoretically give broadcasters better incentives to improve program quality, I doubt very much that Congress or the Commission would conclude that the social benefits of such a policy would outweigh the social costs. Retransmission consent essentially allows broadcasters to indirectly charge some consumers (namely, those that subscribe to MVPDs) for viewing their programming. I think the same considerations that suggest that allowing broadcasters to directly charge ALL consumers a fee to watch their programming would not increase social welfare suggest that allowing broadcasters to indirectly charge SOME consumers a fee to watch their programming would not increase social welfare. In fact, somewhat ironically, to the extent that broadcasters have used revenues from retransmission consent to support their increased investments in MVPD programming, it may well be that revenues the broadcasters receive from retransmission consent have actually been used to support the main competitor to over-the-air broadcasting.

Organization of the Paper

My paper is organized as follows. I devote a separate section to describing each of the four main arguments made by the studies and my detailed responses to each of them. Sections I, II, III, and IV consider, respectively, arguments 1, 2, 3, and 4. Section V draws a brief conclusion.

I. THE MAJOR NETWORKS HAVE MARKET POWER

The authors of the Economists Inc. Study make the claim in various parts of their report that the major networks do not have market power in the sense that they are not able to extract significant compensation from MVPDs in return for providing them with retransmission consent.[4] For example, the Economists Inc. study presents the following statement as a summary of one of the three major points it makes:

> Viacom and other owners of broadcast television stations have 'market power' only in the limited sense that they have some discretion over price, a feature shared with many firms in the economy. Viacom doe not have the type of degree of market power that leads to harm to competition or to consumers.[5]

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4 *See* Economists Inc. Study at 1, 5. Similar statements are also contained in the other two studies. *See, e.g.*, CAP Analysis Study at 15-16 ("[Broadcasters] do not have 'market power' in the sense of being able to force anticompetitive or supra-competitive prices or terms on MVPDs."); BIA Study at 9-12 (section entitled "Overstating the Costs of Retransmission Consent Deals").

5 Economists Inc. Study at 1.

As I explained in my original study, there is essentially universal agreement among market participants and observers, including the major networks themselves, that broadcast programming is unique, highly valued by MVPDs, and difficult to find substitutes for, and that it therefore it only stands to reason that broadcasters should be able to obtain significant compensation for providing MVPDs with this programming just as they are able to obtain compensation for providing them with other types of programming.[6] In fact, the authors of the Economists Inc. study admit as much themselves not only in the study submitted as part of this proceeding, but also in previous studies they have written that the networks have also submitted to the Commission. Therefore, I view their statements to the contrary as being nothing more than attempts to rhetorically muddy the waters rather than attempts to constructively make some real economic point. The Commission should accordingly disregard these statements.

A. The Economic Experts Themselves State Elsewhere in Their Reports that the Major Networks are Able to Extract Significant Compensation from MVPDs in Return for Providing them With Retransmission Consent

Immediately after making the statement quoted above that networks do not have the type of market power that would lead to consumer harm, the authors of the Economists Inc. Study unabashedly admit that networks do, of course, have the power to extract positive compensation for retransmission consent.

> In the bargaining that ensues, it has typically been the case that MVPDs have paid some compensation to the television station. It is not surprising that arm's length, free market negotiations between stations and MVPDs would result in compensation being paid to the television stations. MVPDs pay for the other programming they carry, so it is not unusual for them to pay for television stations' programming.[7]

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6 *See* Rogerson Study at 19-30, 31-38.

7 Economists Inc. Study at 2-3.

Further reading of the Economists Inc. Study reveals that they are apparently attempting to draw some distinction between what they call the "ordinary variety"[8] of market power that is apparently not harmful to consumers and the "troubling"[9] variety that is apparently harmful. This distinction does not make sense. To the extent that broadcasters are able to extract positive compensation for retransmission consent from MVPDs and to the extent that MVPDs pass these cost increases through to their subscribers, retransmission consent creates a social cost. It is a social cost whether one classifies it as an "ordinary variety" of social cost or a "troubling variety" of social cost.

It may be that the authors of the Economists Inc. Study are attempting to make the point that even though retransmission consent creates a social cost, that they believe that it creates social benefits that offset these costs by significantly increasing broadcasters' incentives to produce higher quality programming. Thus the "ordinary variety" of market power might be market power that creates offsetting social benefits, while the "troubling variety" may be market power that does not create offsetting social benefits. I will explicitly argue in section IV that the theoretical argument that the Economists Inc. Study makes in this regard is also flawed. However, for the purposes of this section, my goal is simply to establish the clear and simple point that even the Economists Inc. Study itself admits that it is likely that networks are able to extract significant positive compensation for retransmission consent and that retransmission consent therefore does create a social cost.

Alternatively, it may be that the Economists Inc. Study is simply attempting to argue that the compensation that networks are able to extract from MVPDs is so small that the cost of

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8 *Id.* at 5.

paying this compensation can be ignored. Under this interpretation, the "ordinary variety" of market power would be a level of market power that was small enough that it created insignificant social costs while the "troubling variety" of market power would a level of market power that was large enough that it created significant social costs. However, this interpretation creates logical difficulties of its own. The fact that the networks are vigorously attempting to defend their right to charge for retransmission consent suggests that they believe they are receiving significant compensation from retransmission consent. If the compensation that broadcasters derive from retransmission consent is significant enough that broadcasters perceive a significant benefit from keeping it, then the Commission should conclude that relieving consumers of the obligation to pay this compensation would be a significant benefit to consumers.

Furthermore, in a study the same authors prepared for Disney, that Disney submitted to the Commission in the "*A La Carte Proceeding*,"[10] they explicitly attempt to estimate the fair market value of retransmission consent for ABC and determine that it is between $2.00 and $2.09 per subscriber per month. Even if Disney were able to bargain for half this amount, this would represent a very significant cost to MVPD subscribers. I am puzzled as to how the authors of the Economists Inc. study can simultaneously justify in a single logically consistent framework, their simultaneous claims that networks do not have market power that harms

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[9] *Id.* at 4.

[10] Michael G. Bauman and Kent W. Mikkelsen, "The Fair Market Value of Local Cable Retransmission Rights For Selected ABC Owned Stations," ("Economists Inc. A La Carte Study") July 15, 2005, submitted as exhibit to Comments of The Walt Disney Company, *In the Matter of Comment Requested on A La Carte and Themed Tier Programming and Pricing Options for Programming Distribution on Cable Television and Direct Broadcast Satellite Systems*, MB Docket No. 04-207 ("*A La Carte Proceeding*").

consumers, that networks are able to charge prices for retransmission consent much as any firm supplying programming to MVPDs is able to charge for programming, and that the fair market value of ABC alone is over $2.00 per subscriber per month.

B. Even if the Commission did not Draw Any Conclusions about Networks' Market Power in its Review of the News Corp./ DirecTV Merger, This is at Best A Neutral Statement

In my original study I made the point that, even though the Commission was only directly concerned with evaluating the incremental effects of a vertical merger in its evaluation of the New Corp./DirecTV merger, the Commission nonetheless drew a number of factual conclusions about the general nature of the marketplace for broadcast programming that could usefully inform its current deliberations on the economic effects of retransmission consent regulations. In particular, I argued that the Commission concluded that broadcasters were able to charge MVPDs significant compensation for retransmission consent.[11]

All three economic studies have vigorously disputed my interpretation of the Commission's findings and argued that factual determinations that the Commission may have made about the general marketplace for broadcast programming in order to specifically investigate a particular merger cannot in principle be relevant to any other question the Commission might choose to investigate regarding the marketplace for broadcast programming.[12] I stand by my original interpretation and will of course respectfully leave it to the Commission to determine itself whether or not any of the factual conclusions it drew in its analysis of the News Corp./DirecTV merger are relevant to its current analysis of retransmission consent.

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[11] *See* Rogerson Study at 24-27.

Nonetheless, I would like to point out here that even if it is true that the Commission simply did not consider this issue in its investigation of the News Corp./DirecTV merger and therefore drew no conclusion on this issue, this cannot be interpreted as evidence supporting the networks' claims that they have no market power. I believe that the substantial weight of the evidence presented in this proceeding demonstrates that broadcasters do have market power in the sense that they are able to extract significant compensation from MVPDs in return for providing them with retransmission consent. There is substantial evidence that cable subscribers have responded to the temporary withdrawal of broadcast signals from cable operators by switching to alternate MVPDs, and that the ability of DBS providers to attract customers was significantly increased when they became able to provide local networks to their subscribers.[13] Furthermore, there is essentially universal agreement among market participants and observers, including the major networks themselves, that broadcast programming is unique, highly valued by MVPDs, and difficult to find substitutes for, and that it therefore it only stands to reason that broadcasters should be able to obtain significant compensation for providing MVPDs with this programming just as they are able to obtain compensation for providing them with other types of programming.[14] Finally, it is likely that this market power has increased significantly since the original passage of retransmission consent regulations, because of the additional bargaining leverage that broadcasters have gained over cable MSOs caused by the entry of two DBS providers into most markets.[15]

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[12] *See* Economists Inc. Study at 4-5; CAP Analysis Study at 18-21; BIA Study at 11-12.

[13] Rogerson Study at 20-23.

[14] Rogerson Study at 27-28, 31-38.

[15] *Id.* at 28-31.

C. The Observation that Both MVPDs and Broadcasters have Bargaining Power In No Way Implies that Broadcasters are Unable to Extract Significant Compensation from MVPDs

The Economists Inc. Study and the CAP Analysis Study both specifically cite the Commission's conclusion that both MVPDs and broadcasters have bargaining power in the negotiations over retransmission consent and that a "roughly equal balance of terror"[16] exists between the two parties, and claim that this somehow proves that broadcasters cannot extract significant compensation from MVPDs for retransmission consent.[17] This does not make any sense. For example, suppose we accept the Economists Inc. conclusion that I describe above that the "fair market value" of ABC is approximately $2.00 per subscriber per month. The marginal cost to ABC of supplying this programming to an additional MVPD is likely close to zero. Therefore, the bargaining over the price of retransmission consent will occur in the context of a situation where it costs ABC nothing to supply the network and it is worth $2.00 to the MVPD to receive the network. Simple economic theories of bargaining suggest that if the two parties had equal bargaining power they would agree to a price half-way between these two values, or $1.00.

If all four of the major networks are able to extract $1.00 per subscriber per month from MVPDs and if MVPDs pass most of this cost through to their subscribers, this would mean that the social cost of retransmission consent is approximately $4.00 per subscriber per month. This

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[16] *See In the Matter of General Motors Corporation and Hughes Electronics Corporation, Tranferors And The News Corporation Limited, Transferee For Authority to Transfer Control, Memorandum Opinion and Order*, 19 FCC Rcd 473, 565 ¶ 180 (2004) ("NewsCorp./DirecTV Merger Review Order").

[17] *See* Economists Inc. Study at 2 ("Both MVPDs and television stations benefit when MVPDs carry the stations."); *id.* at 9 (quoting the Commission's "balance of terror" statement and suggesting that this implies that retransmission consent does not harm consumers); CAP Analysis Study at 18-19 (quoting the Commissions "balance of terror" statement and observing that this implies that broadcasters cannot have market power).

is hardly an insignificant amount. More generally, the simple point I am making is that it is not necessary to prove that broadcasters have ALL of the bargaining power in order to prove that they are able to extract significant compensation for retransmission consent. A situation where broadcasters and MVPDs have roughly equal bargaining power could easily result in a relatively high price being charged for retransmission consent.

D. The GAO Study Provides Some Support for the Claim that Broadcasters Have Market Power and Inadequate Data Likely Explains Why it Did Not Find Further Support for this Claim

All three economic studies cite the results of a study by the GAO that finds that broadcaster-owned networks are not able to charge higher license fees than non-broadcaster-owned networks as providing evidence that supports their contention that broadcasters are not able to extract significant compensation for retransmission consent.[18] However, in my original study I provided a detailed explanation of why limitations in the data available to the GAO make this finding unreliable.[19] None of the three economic studies make any attempt to address any of the criticisms that I raised about the GAO study.

Furthermore, all three studies present a misleading and incomplete discussion of the results of the GAO study. As I clearly stated in my original report, the GAO study derives two findings: one of these supports the claim that broadcasters are able to extract compensation from MVPDs for retransmission consent and one of them does not. Specifically, in addition to the finding discussed above, the GAO finds that broadcaster-owned networks are more widely carried than non-broadcaster-owned MVPDs. This finding supports the theory that broadcasters use leverage from retransmission consent to make MVPDs carry programming that they would

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[18] *See* Economists Inc. Study at 11; CAP Analysis Study at 18; BIA Study at 10-11.

otherwise not carry. All three economic studies only choose to mention the GAO results that happen to support their position. It would be much more accurate to describe the GAO study as providing mixed evidence on the issue of whether or not broadcasters have market power.

E. Statistics on Broadcasters' Viewership Shares do Not Refute the Evidence that Broadcasters Have Market Power

One tool that antitrust regulators and economists sometimes use to help assess the level of a firm's market power is to calculate the firm's market share. The Economist's Inc. study performs this type of calculation for CBS by noting that CBS affiliates capture approximately an 11% share of all prime time viewing and suggests that an 11% market share is too small to be consistent with CBS having any market power.[20] In my opinion, no such conclusion is warranted.

This is for the obvious reason that this calculation takes no account of the extent to which products that are defined to be in the same market are actually differentiated from one another. While a low market share may be sufficient to demonstrate the absence of market power when all products that are defined to be in the same market are extremely close substitutes for one another, it is obviously the case that no such conclusion follows automatically in situations where the products that are defined to be in the same market are highly differentiated and therefore potentially poor substitutes for one another. When a market is defined to include products that are highly differentiated from one another, it may be that individual firms have significant market power even if they have relatively low market shares. As I have argued above, substantial evidence exists that television viewers perceive each broadcaster's

[19] *See* Rogerson Study at 37-38 n.64.

[20] *See* Economists Inc. Study at 5 ("Such a share is well below the levels at which economists

programming to be without good substitutes and that broadcasters therefore are able to extract significant compensation from MVPDs for providing them with retransmission consent.

II. WHETHER OR NOT CABLE SUBSCRIPTION PRICES HAVE RISEN BY MORE THAN CAN BE EXPLAINED BY RETRANSMISSION CONSENT IS IRRELEVANT TO COMPARING THE SOCIAL COSTS AND BENEFITS OF RETRANSMISSION CONSENT

A. The Main Argument Made By The Broadcaster Studies

All three studies argue that, even if retransmission consent has caused increases in cable subscription prices, cable subscription prices have risen by more than can be explained solely by retransmission consent. The authors of all three studies appear to believe that this observation somehow supports their contention that retransmission consent does not create significant social costs. As I understand the argument, the studies are attempting to argue that whether or not the price increases caused by retransmission consent are of a significant dollar magnitude is unimportant so long as they represent a small share of the total increases in cable subscription prices that have occurred. This makes no sense. If retransmission consent has caused MVPD subscription prices to increase by a significant dollar magnitude, this is a serious problem that warrants consideration by policymakers regardless of whether or not other factors have also caused additional increases in cable subscription prices.

For example consider the argument presented along these lines in the Economists Inc. Study.[21] They consider a group of 27 networks I list in my original study as being networks that the ACA alleges were carried by their members only because of retransmission consent. The authors of the Economists Inc. study calculate that the license fee increase for these 27 networks

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expect to see market power that would produce anticompetitive results.").

[21] *See* Economists Inc. Study at 10-11.

between 1997 and 2004 was $2.56 per subscriber per month while the total increase in cable subscription prices over this same time period was $14.98. They then, somewhat incredibly, appear to make the argument that even if retransmission consent could therefore be unambiguously blamed for causing cable subscription prices to be $2.56 higher than they should be, that this social cost is insignificant because $2.56 is only 17 percent of $14.98! This does not make any sense. A social cost of $2.56 per subscriber per month is a significant dollar magnitude in and of itself. In my opinion, if the Commission could be certain that retransmission consent caused cable subscription prices to be $2.56 per subscriber per month higher than they should be, this would be a significant cost. The other two studies subscribe to the same faulty logic.[22]

B. The CAP Analysis Critique of My Methodology for Calculating the Share of Increases in Cable Subscription Prices Explained by Increases in Programming Costs is Faulty

In my original study submitted by the Joint Cable Commenters in this proceeding, I described a calculation I had performed in a previous report prepared for Cox Communications[23] in which I calculated that, between 1999 and 2002, license fees that cable systems paid for programming shown on the expanded basic tier increased by $2.96 per subscriber per month while cable subscription prices for the expanded basic tier increased by $7.06 per subscriber per month. I interpreted this calculations as showing that 42% [$2.96/$7.06] of the actual rise in

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22 *See* CAP Analysis Study at 9 (arguing that increases in cable subscription prices causes by increases in program costs are not important because other factors may have caused even larger price increases); BIA Study at 9-10 (arguing that cable subscription prices caused by increases in program costs are not important because the Rogerson study reports that they only explain 42% of the total increase in cable subscription prices.).

23 William P. Rogerson, "Correcting the Errors in the ESPN/CAP Analysis Study On Programming Cost Increases," November 11, 2003.

expanded basic subscription prices during this period could be explained by increases in license fees for expanded basic programming in the sense that this is the amount that prices would have had to rise by in order for cable systems to recover their increased programming costs.

The Cap Analysis Study offers the following critique of my calculation and my interpretation of the calculation.

> [Rogerson's] conclusion is nonsense, as can be seen by applying Rogerson's methodology to the rest of the cost picture. . . When we look at other costs, we see that "Capital Expense" rose by $5.05 between 1999 and 2002, while "Other Operating Expense" rose by $7.33. If we applied Rogerson's methodology to these figures (i.e., divide each by the $7.06 increase in monthly cable rates) we would conclude that Capital Expenses 'explain' 72% ($5.05/$7.06) of the 'actual rise in subscription prices,' while Other Operating Expenses 'explain' 104% ($7.33/$7.06). The three factors taken together, in other words, 'explain' 218% (42% + 72% + 104%) of the rise in cable prices.[24]

This critique demonstrates the authors' basic misunderstanding the distinction between direct and joint costs. Cable systems produce multiple products, including expanded basic cable service, various premium channels, pay-per-view services, and broadband internet services. As I explained completely and fully in my study, the cable subscription price I used in the above calculation was the price of expanded basic service. Similarly the programming cost I used was the cost of license fees for programming shown on the expanded basic tier. The "capital expense" costs and "other operating costs" referred to by the authors in the above quote are joint costs for the business as a whole. Thus my calculation showed how much the price of expanded basic service would have had to rise by in order to cover cost increases that were direct costs solely of providing expanded basic service. This is a sensible calculation that is completely appropriate.

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24 Cap Analysis Study at 10-11.

The authors of the CAP Analysis Study, on the other hand, have calculated how much the price of *expanded basic service* would have had to rise in order to cover costs increases associated with *all of the products* produced by cable operators. This is not a sensible or interesting calculation. It is not surprising that the expanded basic prices did not rise by enough over this period to cover the increase in all of the firms' costs associated with producing all of their products. Presumably, increases in prices of other products covered some of these cost increases too. Thus, the fact that the authors can produce apparently nonsensical numbers when they mindlessly apply my formula in completely inappropriate ways hardly suggests that my formula is flawed.[25]

III. RETRANSMISSION CONSENT MAY HAVE ALLOWED BROADCASTERS TO STRATEGICALLY FORECLOSE POTENTIAL COMPETITORS IN THE MVPD PROGRAMMING INDUSTRY

In my original study I presented evidence that broadcasters appear to have used retransmission consent to greatly expand their presence in the MVPD programming industry. In particular, I argued that (i) there appears to be almost universal agreement among all participants in the market including the networks themselves, that they use retransmission consent as a lever to force additional programming upon MVPDs (ii) broadcaster ownership of MVPD programming has increased dramatically since passage of retransmission consent and, in particular, the passage of retransmission consent regulations appears to be the only reasonable explanation for Fox's dramatic rise in the cable network programming industry; and (iii) the

[25] I should also point out that the authors made another even more elementary error in their attempt to demonstrate that my calculation was "nonsense." Namely, they treated the cost of new investments made during the period as operating costs that should be completely allocated to the periods they were incurred in. Obviously it would be more appropriate to amortize the cost of long-lived assets over the entire period of the assets' useful lives.

GAO's own statistical analysis finds that broadcaster programming is more widely distributed than non-broadcaster programming. I argued that the effect of these tie-ins may have been to foreclose potential competitors in the MVPD programming industry. Retransmission consent would therefore create additional social costs to the extent that this damage to competition resulted in further price increases and MVPDs passed these price increases on to their subscribers.

A. The Vast Bulk of the Most Successful Networks Launched Since Retransmission Consent are Affiliated With Broadcasters

Both the Economists Inc. Study and the CAP Analysis Study have argued that, even if the major networks have significant market power, the evidence shows that they have not be able to use it to foreclose competition in the MVPD programming industry because a significant amount of new non-broadcaster-owned programming has been launched over the last decade since the passage of retransmission consent. As proof, they cite the fact that many new networks not owned by broadcasters have entered the market over the last decade.[26] The flaw with this statistic is of course that it in no way attempts to measure whether or not entry of the new network was successful or not. Many networks fail soon after their launch and even among networks that do not fail, some may turn out to be much more successful than others. Therefore, the real question of interest is not whether or not non-broadcaster-owned networks represent a significant share of all attempted network launches; rather, the question of interest is whether or not non-broadcaster owner networks represent a significant share of the launches of networks that ultimately turn out to be successful and widely distributed. The Joint Cable Commenters ("JCC") presented evidence on precisely this issue in their initial comments which has been ignored by the

[26] *See* Economists Inc. Study at 8; Cap Analysis Study at 16.

Economists Inc. Study and the CAP Analysis Study. Namely, the JCC present data on the twelve most widely carried cable channels launched since retransmission consent was enacted in 1992[27] and summarized the results of this data as follows:

> Eight of these twelve channels are affiliated with one of the Big Four. Furthermore, two of the remaining four were launched by other broadcast groups as consideration for retransmission consent. Therefore, only two channels of the twelve channels launched since the enactment of retransmission consent (i.e., Animal Planet and TCM) are not affiliated with a broadcaster in any way.[28]

Therefore the vast majority of the most successful networks launched since the passage of retransmission consent are in fact broadcaster affiliated. This suggests that successful entry of non-broadcaster-owned networks since the passage of retransmission consent has actually been quite difficult.

B. Very Different Issues Arise in the Analysis of Bundling Program Channels at the Retail Level

In a previous study prepared for Cox Communications,[29] I analyzed the main economic factors that motivate decisions on how to create tiers of programming for sale at the retail level and investigated the issue of how such tiering decisions were likely to affect consumer welfare. The CAP Analysis study correctly points out that I concluded there was likely no need for government to consider interfering with such tiering decisions. In particular, I specifically stated that some tiering was likely desirable because attempting to sell all programming on an a la carte basis would create large "transactions costs.". That is, consumers would find it confusing and burdensome to make individual decisions on more than a hundred individual networks, and the

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[27] JCC Comments at 43, Table D.

[28] JCC Comments at 43.

[29] William Rogerson, "Cable Program Tiering: A Decision Best and Properly Made by Cable System Operators, Not Government Regulators," November 10, 2003 ("Rogerson Tiering

billing and tracking system necessary to implement such a system would also be expensive. I also did NOT discuss the issue of whether or not this bundling at the retail level created a potential for strategic foreclosure of potential competitors and it would be fair to infer from this that I did not think that this was an important issue.

The CAP Analysis Study has correctly noted that, in my discussion of bundling at the wholesale level in this proceeding that I appear to stress different issues.[30] In particular, I do NOT claim that a significant benefit of bundling at the wholesale level is that it is likely to significantly reduce transactions costs, and I DO claim that a potential significant cost of such bundling may be that it allows strategic entry deterrence. I explicitly note in my original study that different issues are important in each of these cases and provide some discussion of what these differences are. Since this discussion was apparently not complete enough for the authors of the CAP Analysis Study, I will expand on it here by making two points.

First, the problem of minimizing transactions costs is an order of magnitude less severe at the wholesale level than the retail level. A consumer purchases perhaps more than 100 different networks from an MVPD; an MVPD may purchase 4 or 5 networks from a particular programmer. Therefore, while private consumers might find it confusing and burdensome to have to make individual choices about more than 100 different networks and different pricing packages for them, I do not think that an MVPD would find it too confusing if it was asked to make separate decisions on each of the 4 or 5 networks it purchases from a particular programmer. Furthermore, the billing and tracking costs for monitoring the thousands of different possible packages of programming that tens of thousands or even millions of individual

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Study").

customers choose at the retail level obviously dwarfs the cost to a programmer of monitoring and tracking the different choices that a small number of MVPDs make from the small number of networks that the programmer offers. Finally, while many analog systems are not currently set up to allow separate delivery of individual programs, obviously at the wholesale level it is technically possible to separately deliver separate networks.

Second, the entry deterrence issue I consider in the case of bundling at the wholesale level simply does not arise at the retail level. Entry deterrence is an issue if a firm has a monopoly of one product, say product A, and there are potentially many different firms that consumers could purchase some other product from, say product B, *even if they purchased product A from the monopolist*. The monopolist can then potentially deter entry of other firms into the B market by bundling A and B together, i.e., by telling consumers that they can only buy A from it if they also agree to buy B from it. In the case of retransmission consent, product A is retransmission consent and product B is MVPD programming. The entry deterrence effect is that a network can potentially deter entry of competitors in the MVPD programming market by telling MVPDs that they can only purchase retransmission consent if they also agree to purchase other MVPD programming from the network. This issue does not arise at the retail level. The analogous issue would occur only if consumers simultaneously purchased different networks from different MVPDs. Then the entry deterrence issue would be that a particular MVPD that had a monopoly on one particular network, could prevent consumers from buying other networks from other MVPDs by bundling. However, because it never makes economic sense for a consumer to simultaneously subscribe to two different MVPDs (and to purchase some networks

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30 *See* CAP Analysis Study at 24-25.

from one MVPD and some networks from the other MVPD)[31] the entry deterrence issue simply does not arise.

C. The Theoretical Models of Strategic Entry Deterrence in the Academic Literature Are potentially Relevant to the Case of Tying Retransmission Consent to Other MVPD Programming Produced by the Network

The CAP Analysis Study also questions whether the entry deterrence models in the academic literature are necessarily relevant to the particular circumstances that exist in the MVPD programming industry.[32] Note, however, that Commission itself has recently referenced and discussed the results of a number of these papers in its A La Carte Report to Congress and explicitly concluded itself that these models are potentially relevant to the case of tying retransmission consent to the purchase of other MVPD programming.

> Some of the sales methods discussed, in combination with various regulatory and technological constraints, may cause harms in the market for video programming. Further, some of these harms may carry through to the retail market and adversely affect consumers. In particular, there is some concern that non-affiliated program networks may not be able to gain widespread carriage due to the industry practice of tying carriage of popular program networks or broadcast stations with carriage of less-popular program networks.[33]

The only specific issue that the CAP Analysis study raises is that it claims that the Whinston paper[34] that I refer to in my original report is not relevant because Whinston's result only holds under the assumption that a firm can commit to bundle products together.[35] I have

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[31] This is because there is a fixed interconnection cost and a low marginal cost of transmitting additional networks over the connection. Therefore simultaneously subscribing to two MVPDs would require the fixed interconnection cost to be incurred twice which is inefficient.

[32] *See* CAP Analysis Study at 26.

[33] *A La Carte Report* at 80.

[34] Michael Whinston, "Tying, Foreclosure, and Exclusion," *American Economic Review*, 80(4), September 1990, 837-859 ("Whinston").

[35] CAP Analysis Study at 26 n.67.

two responses to this point. First, the commitment assumption is only necessary in the simplified expository model that Whinton presents at the beginning of his paper. He goes on to present a more complex, but more general model, where the commitment assumption is not necessary. The simple expository model assumes that all consumers have identical preferences. The more general and more realistic model relaxes this assumption and allows different consumers to have different preferences for the tying good. Whinston summarizes the result of his more general model as follows. (In the following quote "firm 1" refers to the firm tying the products together, and "firm 2" refers to the potential entrant whose entry is deterred by tying.)

> when consumer valuations for the tying good differ, tying can be a profitable strategy for firm 1 even in the absence of an ability to commit, and when it is, it may lower firm 2's profitability in a similar manner to that observed earlier.[36]

Second, even in the simplest model where commitment is required, a firm attempting to deter entry might have an incentive to bundle in order to deter entry if it could develop a reputation for bundling and thereby deter future entry. I think it is very plausible, for example, that the major networks have developed the reputation that they bundle to disadvantage entrants and that this might well deter future entry. This "reputation argument" is closely related to another argument that Whinston makes that "dynamic considerations . . . may be important even when firm 1 cannot pre-commit to tying."[37]

IV. BROADCASTERS HAVE NOT MADE THE CASE THAT RETRANSMISSION CONSENT CREATES SIGNIFICANT OFFSETTING SOCIAL BENEFITS

In my original study, I was extremely clear that the main purpose of my study was to demonstrate that retransmission consent creates significant social costs, and that with respect to

[36] Whinston at 846.

the issue of social benefits, the main point that I was making was that very little evidence of any sort has been presented which suggests that retransmission consent has created significant social benefits. For example, I stated that:

> While my main focus in this paper is to explain why an economic analysis of the available evidence suggests that retransmission consent regulations impose a significant social cost, I also briefly consider the issue of social benefits of this policy. Very little evidence of any sort has been presented suggesting that broadcasters have used the extra revenue stream provided to them by retransmission consent to invest in higher quality broadcast programming.[38]

I explicitly describe my final conclusion as follows in the final sentence of my paper.

> Given that retransmission consent policy appears to create significant social costs and given that the social benefits of this policy are not readily apparent, I conclude that policymakers should attempt to more carefully investigate whether or not there are nay social benefits to this policy, with an eye towards changing the policy unless evidence can be found that significant social benefits exist that outweigh the costs.

I present some examples and data which are meant to be "troubling examples" in the sense that they are meant to raise some serious questions in the reader's mind about whether or not broadcasters have used the revenue stream provided to them by retransmission consent to invest in improving program quality. The migration of ABC's Monday Night Football to ESPN is another such example that has been reported and discussed widely in the press since I wrote my original study. Once again, it is an example where broadcasters are apparently much more enthusiastic about investing in programming to be shown over their MVPD networks than in programming to be shown over their broadcast networks. However, while it is true that I present some examples and data which are meant to be "troubling examples", there is certainly no sense in which I could be interpreted as claiming to provide rigorous empirical evidence on this issue.

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[37] *Id.* at 849.

I would describe my paper as issuing a challenge to supporters of retransmission consent to provide systematic evidence that retransmission consent has had some beneficial effects on program quality. There has been no evidence submitted into the record that adequately responds to this challenge.

A. The Economic Studies' Present Almost No Evidence That Retransmission Consent Has Had Beneficial Effects on Program Quality

Rather than responding to the challenge I raised to them that they should attempt to provide evidence that retransmission consent has had beneficial effects on program quality, the Economists Inc. Study and Cap Analysis Study have presented no such evidence at all and instead focused on presenting detailed arguments explaining why the suggestive examples I presented in my original paper cannot be interpreted as rigorous empirical evidence and instead are really only, at best, suggestive examples. Since this is how I presented these examples in the first place, I am happy to reaffirm in this paper that I view these as suggestive examples rather than as rigorous empirical evidence. The fact still remains, however, that, in my view, the record contains significant evidence that retransmission consent creates social costs and almost no evidence that it creates social benefits that offset these costs.[39]

B. It is Inappropriate To Draw An Analogy Between Normal Competitive Markets Where Free Entry is Possible and the

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[38] Rogerson Study at 5.

[39] The BIA Study has made an attempt to provide some actual evidence on this subject. *See* BIA Study at 3-8. It presents three different examples where broadcasters NOT owned by one of the major networks have apparently used channel space on cable systems granted to them through retransmission consent negotiations to launch locally-oriented networks. While these may well be particular small examples where retransmission consent has had a beneficial effect on program quality, they cannot be interpreted as providing any evidence that retransmission consent has had any larger systematic effects on program quality.

Broadcasting Industry Where Scarce Public Spectrum is Assigned to Broadcasters

The Economists Inc. Study offers the observation that, on a theoretical level, allowing broadcasters to charge MVPDs a price for their product should increase broadcasters' incentives to increase program quality, in much the same way that a firm producing a good in any market will be more likely to supply a higher quality product if it can charge consumers a higher price.[40] According to this reasoning, since we let producers charge consumers an unregulated price for their products in most markets, then it would also be a good idea to let them do this in the market for broadcast programming.

This argument conveniently ignores the fact that the broadcast spectrum is a scarce resource, that society has given a small number of broadcasters access to this limited resource, and that competitive entry of additional over-the-air broadcasters is simply not possible. The fallacy in this reasoning is illustrated by the fact that it clearly "proves too much." That is, the same argument could be used to support the policy recommendation that broadcasters be allowed to scramble their over-the-air signals and directly charge all consumers a monthly fee to rent a descrambling device. According to the logic of the three economic studies, this would simply allow a "normal market" to function in broadcasting and therefore benefit consumers. While a policy of having everyone-pays over-the-air TV might theoretically give broadcasters better incentives to improve program quality, I doubt very much that Congress or the Commission would conclude that the social benefits of such a policy would outweigh the social costs. Retransmission consent essentially allows broadcasters to indirectly charge some consumers

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[40] *See* Economists Inc. Study at 12 ("Economic theory predicts that granting television stations the opportunity to be compensated for retransmission consent should increase the incentives to provide attractive programming.)

(namely, those that subscribe to MVPDs) for viewing their programming. I think the same considerations that suggest that allowing broadcasters to directly charge ALL consumers a fee to watch their programming would not increase social welfare, suggest that allowing broadcasters to indirectly charge SOME consumers a fee to watch their programming would not increase social welfare either.

In fact, somewhat ironically, to the extent that broadcasters have used revenues from retransmission consent to support their increased investments in MVPD-programming, it may well be that revenues the broadcasters receive from retransmission consent have actually been used to support the main competitor to over-the-air broadcasting.

V. CONCLUSION

In my original study, I demonstrated that retransmission consent policy likely creates significant social costs and that there was very little evidence that it results in any significant benefits that offset these costs. The three economic studies submitted by broadcasters along with their reply comments are not able to refute my conclusion that retransmission consent likely creates significant social costs. They have also not been able to make the case that the policy creates significant social benefits that offset these costs. I conclude that policymakers should seriously consider changing this policy.

I declare that the foregoing is true and correct:

Bill Rogerson

William P. Rogerson

Dated:

May 23, 2005